

**CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM
STATEMENT OF INVESTMENT POLICY**

**FOR
FRANCHISE FINANCE REAL ESTATE**

August 16, 2004

This Policy is effective immediately upon adoption and supersedes all previous franchise finance real estate investment policies.

I. PURPOSE

This document sets forth the investment policy ("the Policy") for the Franchise Finance Real Estate Portfolio (collectively referred to as "the Portfolio"). The design of this Policy ensures that investors, managers, consultants, or other participants selected by the California Public Employees' Retirement System ("the System") take prudent and careful action while managing the Portfolio. Additionally, use of this Policy provides assurance that there is sufficient flexibility in controlling investment risks and returns associated with franchise finance investments.

II. STRATEGIC OBJECTIVE

Achieving the highest total rate of return possible consistent with a prudent level of risk and the liabilities of the System and the investment guidelines contained herein is the strategic objective of this Policy. This Portfolio shall be considered a component of the Specialized Equity Real Estate Portfolio, and as such, shall be required to achieve an appropriate risk-adjusted return. The Portfolio shall be managed to assist the System in achieving its long-term objective of exceeding a minimum target real rate of return of 6.0% (after fees). The Portfolio shall be expected to achieve a real rate of return consistent with other equity real estate investments of similar risk.

The Portfolio shall be subject to the investment processes described in the Statement of Objectives and Policies for the Equity Real Estate Portfolio and the Delegations of Authority incorporated herein by reference hereto. Investment in franchise finance shall be undertaken only if consistent with the System's objectives of capital preservation, diversification of risk, and achievement of real rates of return.

The Portfolio shall be managed to accomplish the following:

- A. Preserve investment capital;

- B. Generate attractive risk-adjusted rates of return for the System as a total return investor;
- C. Provide a source of cash flow;
- D. Provide a hedge against inflation; and
- E. Consider solely the interest of the System's participants and beneficiaries in accordance with California State Law.

III. INVESTMENT APPROACHES AND PARAMETERS

A. Risks

1. Several unique risks are associated with investments in franchise finance, which include the following:
 - a. Franchised restaurant buildings are special purpose facilities. Although it may be possible to reuse the buildings for other purposes, the cost of retrofitting may be expensive or prohibitive;
 - b. Each unit has a single tenant, which means that in the event of tenant default, the entire property produces no income; and
 - c. The restaurant industry is cyclical and has some systematic risk.
2. Some of these disadvantages are mitigated, by the following considerations:
 - a. Many franchised restaurant buildings can be reused efficiently for other restaurant operations;
 - b. The default rate on high-grade franchised restaurants is low; and
 - c. The franchise finance investment structure provides an attractive combination of base return (rent), as well as a participation in gross sales, thereby allowing the income stream to keep pace with, or even exceed, inflation levels.

B. Diversification

The Portfolio should be well diversified to minimize risks due to overexposure to any one risk factor (e.g., region, concept, segment, and operator). The Portfolio should be diversified along the following criteria:

1. Geographical location;
2. [Franchiser](#)/franchised chain company;
3. [Operator/franchisee](#) of the restaurant unit(s);
4. Concept/type (hamburgers vs. fish, or hamburgers vs. ethnic, and so forth); and
5. Market segment (targeted segment of the restaurant market as defined by the price of the average meal).

C. Size

1. Investments in commingled funds shall not exceed 25% of any one Fund; and
2. Investment transaction size shall be limited to transactions that include a minimum of \$5 million. Typically, franchise finance transactions range in size from three to five units (e.g., restaurants), at an average value of \$750,000 to \$850,000 per unit.

D. Structure

1. The System may invest in any one or any combination of the following structural components of franchise finance, with the exception that investments made solely in trade equipment are not preferred:
 - a. Land on which the property is situated;
 - b. Building improvements; and
 - c. Trade equipment necessary for operations.
2. The System may structure investments in the following manner:
 - a. All three elements can be owned by the investor and leased to the operator;

- b. All three elements can be owned by the operator and mortgaged to the investor; or
 - c. In some cases, a portion of the investment can be in the form of an owner/lessee relationship, while another portion is in the form of a lender/borrower relationship.
- 3. The System shall evaluate opportunities in the context of their individual risk and reward characteristics.
 - 4. The preferred form of financial structure for the System is an opportunity that includes some form of base rent increased periodically plus income participation at the individual unit (restaurant) level. Other structures shall be considered on an individual basis.

E. Vehicles

- 1. The System may invest in either a direct investment or an indirect commingled fund, as appropriate, depending upon the nature of the investment. The advantages and disadvantages of each structure shall be considered by the System when selecting the appropriate vehicle.
- 2. Generally, commingled funds shall be utilized when their diversification benefits are most desirable, while direct investments shall be utilized when closer control over the investment, at a lower fee structure, is the primary concern.
- 3. Direct investments shall be the preferred vehicle for portfolios of units that minimize the need for diversification by virtue of their strength in the marketplace and stronger credit characteristics. Such portfolios include investments in existing properties, with relatively large franchisers, operated by franchisees with a relatively large number of units dominant in their market, and when the transaction size is relatively large.
- 4. Commingled funds shall be generally more appropriate for smaller, less established franchises, with smaller, less established operators, as well as a smaller transaction size. Investments in speculative development opportunities shall be generally made through a commingled fund and have a relatively high return expectation.

5. To ensure adequate diversification, the System shall consider only those investment vehicles that include numerous individual properties.
6. To ensure appropriate portfolio diversification, the System shall consider the timing, prioritization, and characteristics of each investment.

F. Selection of Management Firms

1. The System shall invest in real estate franchise finance on a direct or indirect basis through third-party investment advisors, general partners, operating company management teams or other organizations with specific expertise in specialized real estate investments (collectively referred to as "Management Firms"). Management Firms shall provide expertise and experience in locating, negotiating, monitoring, and disposing of franchise finance investments. The System shall establish and document specific, relevant selection criteria for each Management Firm prior to selection to establish the basis on which the selection shall be made. The System shall approve Management Firms based on their successful history or significant potential in managing and implementing specialized real estate investment programs, and their reputation.
2. Selection of Management Firms is critical to the success of the Program due to the non-traditional, highly specialized nature of franchise finance. Management Firms selected by the System shall have investment and asset management discretion, with oversight and periodic review by the System.
3. Management Firms shall represent only the interests of the System in these transactions or only the interests of the investor group if the System co-invests with another client or other clients of the advisors.

G. Investment Criteria

The System shall direct its investments to franchise finance properties and portfolios with the characteristics listed as follows in paragraphs one through five. Strict adherence to these guidelines is not mandated but, rather, transactions that do not conform to the guidelines are subject to additional review.

1. [Property Life Cycle](#) - To ensure restaurant success, the System shall generally invest in existing franchise restaurants at already

established locations or in those that meet other demographic criteria.

2. Franchiser - The System shall limit investments to those franchises that represent recognized national franchises or very strong regional franchises. Acknowledging that any specific threshold is somewhat arbitrary, the System shall generally limit investments to restaurant franchisers with gross system sales in excess of \$500 million (in 1999 dollars). This threshold includes approximately 25 to 30 franchisers at present. In addition to strong chain-wide sales, franchisers should also have strong average unit sales.
3. [Market Position](#) - The System shall limit investment to units affiliated with franchises that have a major presence in the specific market area in which the investment is contemplated. Generally, franchisers should be the first or second largest franchise within a specific restaurant concept. Thus, the System shall not invest in a unit that represents, for example, the fourth largest "fish" concept in its market, regardless of the national sales volume for the franchiser. Some concepts such as "hamburger," however, are deeper and, in such instances, may merit an investment in the third or even fourth largest franchise.
4. Operator/Franchisee - Generally, the System shall limit investment to operators with 10 or more units under management. This limitation shall help ensure that experienced franchisees operate the System's investments. All operators should be experienced with solid net worth and proven operational skills.
5. [Property Sites](#) - Properties shall be located along major thoroughfares, near employment centers, or within established retail districts with convenient access and good visibility. Locations should demonstrate demographic strength, economic viability, site utility, adequate size, and community acceptance.

H. Asset Management

The System's advisors and Management Firms responsible for the Portfolio shall represent the System's interest in asset management decisions, providing daily property management services, as expertise and organizational structure allow. The System shall give Management Firms the appropriate delegation of authority along with requiring appropriate measures of accountability. Advisors and Management Firms shall represent only the System's interests in these transactions or only the interests of the investor group if the System co-invests with other clients in such transactions.

All relevant financial and operational controls, as well as reporting requirements applied to other equity real estate investments, may be modified to reflect the specific asset management requirements of the Portfolio.

IV. GENERAL

Members of the System developed this Policy primarily with respect to restaurant franchises. Though the more general precepts and guidelines embodied in this Policy remain valid regardless of the specific underlying industry, the System recognizes that some of the more specific guidelines may need to be revised in the context of investments in underlying industries other than restaurants, should such opportunities arise.

Franchise finance is considered a Specialized Real Estate Investment as it offers the opportunity for the System to diversify its Equity Real Estate Portfolio, and thereby helps to minimize overall portfolio risk by investing in a property type other than Core. An investment in franchise finance is essentially an investment in the restaurant industry; the performance of the investment relates directly to the success of the franchised restaurant's operations due to a portion of the lease income being a percentage of restaurant sales.

V. ASSET ALLOCATION

Allocations to the Portfolio shall be consistent with allocation parameters for Core and Specialized Real Estate Investments in the Statement of Investment Policies, Guidelines, and Procedures for the Equity Real Estate Portfolio. As a percent of the total allocated Specialized Real Estate Portfolio, this Portfolio in aggregate with other Alternative Strategies¹ as further defined in the Specialized Policy, shall range from 0 to 30%.

From time to time, the actual investment may fall out of the allocation ranges prescribed by the Policy. In these instances, adjustments to correct the actual to comply with the Policy allocation ranges shall be implemented on an opportunistic basis over a reasonable time frame (normally within a three-year period) and with ample consideration given to preserving investment returns to the System.

VI. VALUATION

Unless otherwise noted, investors, managers, consultants, or other participants selected by the System shall base all calculations and computations on fair market value. Market value, as used in such calculations, is defined by the

¹ Alternative Strategies to include opportunistic investment, Hotels, Franchise Finance, and Mezzanine Debt Investment Programs.

Uniform Standards of Professional Appraisal Practice (USPAP) of the Appraisal Foundation and shall be incorporated when reporting fair market value for accounting purposes.

VII. GLOSSARY OF TERMS

The Real Estate Glossary of Terms is referenced in the CalPERS Master Glossary of Terms.